

## 1. Modes of Reconstitution

A partnership firm can be reconstituted in several ways:

- **Admission of a New Partner:** When additional capital or managerial help is required.
- **Change in Profit Sharing Ratio (PSR):** When existing partners decide to alter their roles or contributions.
- **Retirement of a Partner:** Due to bad health, old age, or other interests.
- **Death of a Partner:** If remaining partners choose to continue the business.
- **Insolvency of a Partner:** Where a partner is unable to meet their liabilities.

## 2. Changes in Profit Sharing Ratio: Sacrificing and Gaining Ratio

When PSR changes, some partners gain a share in future profits while others lose a portion. This necessitates the calculation of two key ratios:

### A. Sacrificing Ratio

The sacrificing ratio is the ratio in which old partners forgo their share of profit in favour of an incoming partner or another existing partner.

- **Formula:**  $\text{Sacrificing Ratio} = \frac{\text{Old Share} - \text{New Share}}{\text{Old Share}}$
- **Importance:** It is used to distribute the premium for goodwill brought by a new partner.

### B. Gaining Ratio

The gaining ratio is the ratio in which continuing partners acquire the share of a retiring or deceased partner.

- **Formula:**  $\text{Gaining Ratio} = \frac{\text{New Share} - \text{Old Share}}{\text{New Share}}$
- **Importance:** It is used to determine how much the gaining partners must compensate the outgoing partner for their share of goodwill.

## 3. Goodwill: Nature, Factors, and Valuation

### Nature and Factors

Goodwill is an intangible asset representing the value of a firm's reputation, which enables it to earn super profits (profits above the normal rate of return).

Factors affecting its value include:

- **Nature of Business:** Firms producing high value-added products or having stable demand.
- **Location:** Favourable or central locations with heavy customer traffic.
- **Efficiency of Management:** Well-managed concerns enjoy higher productivity and cost efficiency.
- **Market Situation:** Monopolies or limited competition.
- **Special Advantages:** Possession of import licences, patents, or trademarks.

### Methods of Valuation

1. **Average Profits Method:** Goodwill is valued at an agreed number of "years' purchase" of the average profits of the past few years. It can be Simple Average or Weighted Average (giving higher weight to recent years).

2. **Super Profits Method:** Based on profits earned in excess of the Normal Profit.

- Normal Profit =  $(\text{Firm's Capital} \times \text{Normal Rate of Return}) / 100$ .
- Super Profit = Average Profit – Normal Profit.
- Goodwill = Super Profit × Number of Years' Purchase.

3. **Capitalisation Method:**

- **By Average Profits:** Capitalised Value – Net Assets.
- **By Super Profits:**  $(\text{Super Profits} \times 100) / \text{Normal Rate of Return}$ .

#### 4. Revaluation of Assets and Reassessment of Liabilities

During reconstitution, assets and liabilities are brought to their current values via a Revaluation Account (also called Profit and Loss Adjustment Account).

- **Debit Side:** Records decrease in assets, increase in liabilities, and unrecorded liabilities.
- **Credit Side:** Records increase in assets, decrease in liabilities, and unrecorded assets.
- **Result:** The net gain or loss on revaluation is transferred to the old partners' capital accounts in their old profit sharing ratio.



#### 5. Distribution of Reserves and Accumulated Profits

A new partner is not entitled to any share of profits earned before their admission. Similarly, an outgoing partner is entitled to their share of profits earned while they were a partner.

- **Accumulated Profits/Reserves:** General reserves, reserve funds, or credit balances of P&L are transferred to old partners' capital accounts in their old PSR.
- **Accumulated Losses:** Debit balances of P&L or deferred revenue expenditure are debited to old partners' capital accounts in their old PSR.

#### 6. Admission of a Partner

##### Effects and Rights

Admission leads to the creation of a new agreement. The new partner acquires two main rights: the right to share firm assets and the right to share future profits. In return, they bring capital and a premium for goodwill.

##### Accounting Treatment for Goodwill (AS 26)

According to Accounting Standard 26, only purchased goodwill is recorded in the books. Self-generated goodwill is adjusted through partner capital accounts.

- **Case 1:** Premium brought in cash: The amount is credited to the sacrificing partners in their sacrificing ratio.
  
- **Case 2:** Premium not brought in cash: The new partner's current account is debited, and sacrificing partners' capital accounts are credited in their sacrificing ratio.
  
- **Hidden Goodwill:** If goodwill isn't specified, it is inferred by comparing the total capital of the firm (based on the new partner's contribution) with the actual combined capital of all partners.

## 7. Retirement and Death of a Partner

The accounting treatment for retirement and death is largely similar, as both involve settling the claims of an outgoing partner.

### Ascertaining the Amount Due

The total amount due to the retiring partner or the deceased partner's legal representatives (executors) includes:

1. Credit balance of capital and current accounts.
  
2. Share of goodwill.
  
3. Share of accumulated profits/reserves.
  
4. Share in revaluation gain.
  
5. Share of profit up to the date of retirement/death.

### Profit for the Intervening Period

If a partner leaves in the middle of a year, their share of profit from the last Balance Sheet date to the date of departure is calculated based on:

- **Time Basis:** Using previous year's profit or average profits.
  
- **Turnover/Sales Basis:** Using sales of the current period compared to the previous year's sales and profit.
  
- **Journal Entry:** Profit and Loss Suspense A/c  
 Dr. to Outgoing Partner's Capital A/c.

### Settlement of Dues

The amount due can be settled in three ways:

1. **Lump Sum:** Paid immediately in cash.



### Adjustment of Capitals

Partners may agree to adjust their capitals to be proportionate to their new PSR. The new partner's capital is often used as a base. Any surplus is withdrawn, and any deficiency is brought in by the respective partners.

2. **Loan Account:** The amount is treated as a loan carrying interest (at 6% p.a. if the deed is silent, as per Section 37 of the Partnership Act).
  
3. **Installments:** Paid over time with agreed interest.

### Specific Accounts for Death

In the case of death, the deceased partner's capital account is closed by transferring the balance to their Executor's Account. The executors are then paid according to the agreement or the provisions of the law.

